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FORTUNE

SECRETS OF MARC RICH

DEALS OF THE YEAR

MICROSOFT'S DRIVE TO DOMINATE SOFTWARE

WHERE MGM, THE NCAA, AND JERRY FALWELL FIGHT FOR CASH

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Wanted in the U.S. on charges of tax fraud, big-time commodities trader Marc Rich is still dealing in Zug, Switzerland, where this picture was taken by telephoto lens. For a behind-the-curtains report on his past triumphs and present troubles, see page 44.

FORTUNE

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DEALS OF THE YEAR

■ The movement away from conglomeration was evident in 1983's grand-scale business deals. Corporate acquirers tended to go for the industries they knew best—their own. Among the mergers and acquisitions in FORTUNE's directory of the year's biggest deals, same-industry combinations predominated. The old diversification pattern turned up in only two deals.

One notable feature of the year's biggest deals is activity among railroad holding companies. The biggest deal of all was the merger of Santa Fe Industries and Southern Pacific, completed less than ten days before the year ran out. The latter company's shareholders received $2.3 billion. Southern Pacific appears on the list a second time with the $727-million sale of its communications subsidiaries to GTE (deal No. 22). That's deglomeration. Two railroad holding companies with large reserves of natural resources acquired more. CSX paid over $1 billion for Texas Gas Resources (deal No. 6), and Burlington Northern acquired most of El Paso's stock in two transactions totaling $1.2 billion (No. 29 and No. 36).

The total value of 1983's 50 biggest deals came to $38.4 billion, down from $48.2 billion the year before. The mix of corporate combinations and securities offerings changed dramatically from 1982 to 1983. The number of corporate linkings fell from 33 to 20, while the number of offerings rose from 17 to 30. The notes on page 58 explain the criteria for the list.

Those 30 securities offerings raised some $20 billion in the public markets, up from the corresponding figure of $13.7 billion for 1982. Because of the huge scale of its mortgage buying, the Federal National Mortgage Association—the largest diversified financial company in the U.S.—appears no fewer than 22 times on the 1983 list, with sales of more than $14 billion of debentures.

Four of Fannie Mae's offerings hit the billion-dollar mark, a stratosphere that few businesses ever reach. But two telecommunications giants did make it this time, and both offerings set all-time records on Wall Street. In a prelude to its breakup, AT&T's final trip to the stock market raised almost $1.2 billion in the largest stock offering ever (No. 4). Competitor MCI Communications arranged the largest package of notes and warrants ever offered directly to the public—$1 billion (No. 8). Yet another Wall Street record was set by Merrill Lynch's initial offering of stock in a new high-tech investment fund (No. 30). It turned out to be the largest mutual fund offering so far, raising more than $600 million before the deal was closed.

AMONG MERGERS and acquisitions, oil and gas deals were plentiful in 1983, as in past years—in ten deals, at least one of the companies was involved in oil or gas in some way. Already big financial services companies continued to grow. American Express purchased the French, Swiss, and other non-U.S. banking operations of Edmond Safra's Trade Development Bank (No. 33). Financial Corp. of America acquired an even heftier California outfit, First Charter Financial, creating the nation's largest savings and loan association (No. 16).

A striking exception to the pattern of same-industry combinations was Xerox's purchase of Crum & Forster for $1.6 billion (No. 2). The deal was announced in September 1982, but various delays held up completion until last January. The deal was "an aberration for 1983," says Barry Friedberg, a managing director at A.G. Becker Paribas. "It's possible that Xerox fears the inroads the Japanese have made in the copier market and wanted to get into other businesses."

As usual, the financial intermediaries that helped with the deals fared well. Their total fees from all 50 topped $260 million, up from $221 million in 1982. In fees from mergers and acquisitions, Goldman Sachs got the most, $22 million. First Boston came in second, with $15 million. In 1982 First Boston was No. 1 and Goldman Sachs No. 2.

Some big deals that made news in 1983 do not appear on the list because consummation was still pending at year-end. One deal-in-progress that would have ranked near the top is the purchase of CIT Financial by Manufacturers Hanover for $1.5 billion. American Express is in the process of buying Investors Diversified Services, and after more than a year of negotiations, General Electric may finally complete the sale of its mining subsidiary, Utah International. See next year's directory.

ROBERTO BROSAN

BIGGEST DEALS OF 1983

▭ MERGERS AND ACQUISITIONS ▭ DEBT AND EQUITY OFFERINGS

Rank	Value of deal (000)	Percent of book value	Transaction	Companies	Financial intermediaries	Fee (000)	Fee as percent of deal
1	**SANTA FE INDUSTRIES (transportation and natural resources) merges with SOUTHERN PACIFIC (transportation and natural resources)**						
	2,308,804[1]	86%	Merger by exchange of common stock to form Santa Fe Southern Pacific, December 23	Santa Fe	Salomon Brothers	$1,500	.06%
				Southern Pacific	Morgan Stanley	$6,721	.29%
2	**XEROX acquires CRUM & FORSTER (insurance)**						
	$1,637,255	156%	Acquisition for cash, common and preferred stock, January 11	Xerox	Goldman Sachs Salomon Brothers	$2,500 $2,500	.15% .15%
				Crum & Forster	First Boston	$575	.04%
3	**DIAMOND SHAMROCK (oil and gas) acquires NATOMAS (oil and geothermal energy)**						
	$1,516,775	N.A.	Acquisition for common and preferred stock, August 31[2]	Diamond Shamrock	Kidder Peabody	$4,000	.26%
				Natomas	Lazard Frères Salomon Brothers	$3,000 $3,000	.20% .20%
4	**AMERICAN TELEPHONE & TELEGRAPH sells stock**						
	$1,166,000	97%	Offering of 17.6 million shares of common stock at $66.25, March 10	AT&T	Morgan Stanley*, Goldman Sachs, E.F. Hutton, Merrill Lynch White Weld, Salomon Brothers	$22,880	1.96%
5	**PHILLIPS PETROLEUM acquires GENERAL AMERICAN OIL CO. OF TEXAS**						
	$1,140,549	232%	Acquisition for cash, March 8	Phillips	Goldman Sachs	$4,000[3]	.35%
				General American	First Boston Kidder Peabody Blyth Eastman Paine Webber	$5,700 $1,240 $750[3]	.50% .11% .07%
6	**CSX (transportation and natural resources) acquires TEXAS GAS RESOURCES (transportation and natural resources)**						
	$1,053,465	157%	Acquisition for cash and common stock, October 1	CSX	First Boston	$3,300	.31%
				Texas Gas	Goldman Sachs	$3,325	.32%
7	**SIGNAL (multi-industry) acquires WHEELABRATOR-FRYE (engineering and manufacturing)**						
	$1,041,078	129%	Acquisition for common stock, February 1	Signal	None	—	—
				Wheelabrator-Frye	Lazard Frères	$2,500	.24%
8	**FEDERAL NATIONAL MORTGAGE ASSOCIATION (mortgage holder) sells debentures**						
	$1,000,000		Offering of 10.9% debentures due 1987, February 10	Federal National Mortgage Association	Various dealers	$2,000	.20%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$1,000,000		Offering of 10.4% debentures due 1988, March 10	Federal National Mortgage Association	Various dealers	$1,850	.19%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$1,000,000		Offering of 10.45% debentures due 1988, April 11	Federal National Mortgage Association	Various dealers	$1,820	.18%
	MCI COMMUNICATIONS (telecommunications) sells notes and warrants						
	$1,000,000		Offering of one million units consisting of $1,000 subordinated notes at 9.5% due 1993 and 18 warrants for common stock at one share per warrant, July 29	MCI	Drexel Burnham Lambert*, Shearson/American Express	$13,750	1.38%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$1,000,000		Offering of 11.2% debentures due 1987, October 11	Federal National Mortgage Association	Various dealers	$1,689	.17%
13	**ESMARK (food and consumer products) acquires NORTON SIMON (food and consumer products)**						
	$977,362	158%	Acquisition for cash and preferred stock, September 9	Esmark	A.G. Becker Paribas Oppenheimer	$1,500 $1,500	.15% .15%
				Norton Simon	Goldman Sachs Lazard Frères Salomon Brothers	$2,500 $2,500 $2,500	.26% .26% .26%
14	**SOUTHLAND (convenience retailing) acquires CITGO PETROLEUM [Occidental Petroleum]**						
	$938,826	N.A.	Acquisition for cash and common stock, August 31	Southland	Dean Witter Reynolds	$1,500	.16%
				Occidental Petroleum	Goldman Sachs	N.A.	N.A.

*Fortune estimate. *Lead manager. N.A. Not available.
[1]Valued as if Southern Pacific were the acquired firm.
[2]Does not include Natomas transportation and real estate subsidiaries that were spun off to Natomas shareholders.
[3]For advice during unsuccessful tender offer by Mesa Petroleum.

BIGGEST DEALS OF 1983

Rank	Value of deal (000)	Percent of book value	Transaction	Companies	Financial intermediaries	Fee (000)	Fee as percent of deal
15	**WILLIAMS (fertilizer, energy, and metals) acquires NORTHWEST ENERGY (natural gas)**						
	$876,720[4]	193%	Acquisition for cash, November 30	Williams	Smith Barney Harris Upham	$4,000	.46%
				Northwest Energy	Goldman Sachs	$5,000*	.57%
16	**FINANCIAL CORPORATION OF AMERICA (financial services) acquires FIRST CHARTER FINANCIAL (financial services)**						
	$851,775	133%	Acquisition for cash, common and preferred stock, August 5	FCA	Bear Stearns	$1,900	.22%
				First Charter	First Boston	$475	.06%
17	**INTERNORTH (oil and gas) acquires BELCO PETROLEUM**						
	$828,973	124%	Acquisition for cash and preferred stock, August 1	InterNorth	Blyth Eastman Paine Webber	$1,000	.12%
				Belco Petroleum	Goldman Sachs	$2,700	.33%
18	**GOODYEAR TIRE & RUBBER acquires CELERON (oil and gas)**						
	$816,933	248%	Acquisition for common stock, June 20	Goodyear	Lehman Brothers Kuhn Loeb Dillon Read	$2,400 $1,000	.29% .12%
				Celeron	Lehman Brothers Kuhn Loeb Merrill Lynch White Weld	$2,400 $800	.29% .10%
19	**FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures**						
	$800,000		Offering of 9.85% debentures due 1987, May 10	Federal National Mortgage Association	Various dealers	$1,278	.16%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$800,000		Offering of 11% debentures due 1986, July 11	Federal National Mortgage Association	Various dealers	$1,125	.14%
21	**CITICORP sells notes**						
	$749,063		Offering of floating-rate notes due 1992, March 3	Citicorp	Salomon Brothers*, Goldman Sachs, Merrill Lynch White Weld	$3,750	.50%
22	**GTE (telecommunications) acquires communications and satellite subsidiaries of SOUTHERN PACIFIC**						
	$727,400	N.A.	Acquisition for cash, June 15	GTE	Lehman Brothers Kuhn Loeb	$350*	.05%
				Southern Pacific	Morgan Stanley	$3,200*	.44%
23	**FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures**						
	$700,000		Offering of 10.45% debentures due 1988, January 10	Federal National Mortgage Association	Various dealers	$1,400	.20%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$700,000		Offering of 9.9% debentures due 1987, January 18	Federal National Mortgage Association	Various dealers	$1,225	.18%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$700,000		Offering of 10.3% debentures due 1990, May 10	Federal National Mortgage Association	Various dealers	$1,613	.23%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$700,000		Offering of 10.7% debentures due 1987, June 10	Federal National Mortgage Association	Various dealers	$1,033	.15%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$700,000		Offering of 11.55% debentures due 1987, September 12	Federal National Mortgage Association	Various dealers	$1,173	.17%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$700,000		Offering of 10.95% debentures due 1986, November 10	Federal National Mortgage Association	Various dealers	$850	.12%
29	**BURLINGTON NORTHERN (transportation and natural resources) acquires EL PASO (oil and gas)**						
	$664,213	193%	Acquisition of 52% for cash and preferred stock, December 13[5]	Burlington Northern	Shearson/American Express Lehman Brothers Kuhn Loeb	$600 $125	.09% .02%
				El Paso	Salomon Brothers	$1,000	.15%
30	**SCI/TECH HOLDINGS (mutual fund) sells stock**						
	$600,653		Initial offering of 60,065,293 shares of common stock at $10, February 28[6]		Merrill Lynch, Pierce, Fenner & Smith	$39,266	6.54%

*Fortune estimate. [1]Lead manager. N.A. Not available.
[4]Includes $26.72 million paid to Allen & Co. for options on 3.34 million shares of Northwest common stock.
[5]Burlington Northern had previously purchased 48% of El Paso.
[6]Offering was closed on March 31.

Rank	Value of deal (000)	Percent of book value	Transaction	Companies	Financial intermediaries	Fee (000)	Fee as percent of deal
31	**KROGER (retail food and drugs) acquires DILLON COMPANIES (retail food)**						
	$600,186	279%	Acquisition for cash and common stock, January 25	Kroger	Goldman Sachs Blyth Eastman Paine Webber	$2,000 $500	.33% .08%
				Dillon	Merrill Lynch White Weld	$2,749	.46%
32	**FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures**						
	$600,000		Offering of 11.15% debentures due 1987, December 12	Federal National Mortgage Corporation	Various dealers	$855	.14%
33	**AMERICAN EXPRESS acquires the non-US banking business of TRADE DEVELOPMENT BANK HOLDING**						
	$555,355	N.A.	Acquisition for cash, common stock, and common stock warrants, July 25	American Express	None	—	—
				Trade Development Bank	None	—	—
34	**FORT HOWARD PAPER (paper products) acquires MARYLAND CUP (paper products)**						
	$532,985	197%	Acquisition for cash and common stock, August 31	Fort Howard	Morgan Stanley	$2,563	.48%
				Maryland Cup	Lehman Brothers Kuhn Loeb	$2,732	.51%
35	**NEWCO HOLDING (DONALD L. BREN) acquires additional interest in and merges with IRVINE (real estate)**						
	$518,000	N.A.	Acquisition of 51.5% for cash, April 15[7]	Newco	Allen & Co.	N.A.	N.A.
				Irvine	First Boston[8]	$5,300[e]	1.02%
36	**BURLINGTON NORTHERN makes tender offer for EL PASO**						
	$504,000	222%	Cash tender for 39.2%, February 7	Burlington Northern	Shearson/American Express	$3,000	.60%
				El Paso	Merrill Lynch White Weld	$1,800	.36%
37	**FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures**						
	$500,000		Offering of 10.9% debentures due 1993, January 10	Federal National Mortgage Association	Various dealers	$1,500	.30%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$500,000		Offering of 10.95% debentures due 1993, March 10	Federal National Mortgage Association	Various dealers	$1,395	.28%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$500,000		Offering of 10.1% debentures due 1986, March 10	Federal National Mortgage Association	Various dealers	$796	.16%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$500,000		Offering of 10.125% debentures due 1986, April 11	Federal National Mortgage Association	Various dealers	$796	.16%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$500,000		Offering of 10.875% debentures due 1993, April 11	Federal National Mortgage Association	Various dealers	$1,365	.27%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$500,000		Offering of 10.3% debentures due 1988, April 26	Federal National Mortgage Association	Various dealers	$1,000	.20%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$500,000		Offering of 11.7% debentures due 1986, August 10	Federal National Mortgage Association	Various dealers	$750	.15%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$500,000		Offering of 11.7% debentures due 1988, November 10	Federal National Mortgage Association	Various dealers	$970	.19%
45	**CHRYSLER sells stock**						
	$432,250	See footnote[9]	Offering of 26 million shares of common stock at $16.625, March 29	Chrysler	Salomon Brothers*, First Boston*, Lehman Brothers Kuhn Loeb, E.F. Hutton, Merrill Lynch White Weld	$22,880	5.29%
46	**BROWN-FORMAN DISTILLERS (alcoholic beverages) acquires LENOX (china, jewelry, luggage)**						
	$409,291	296%	Acquisition for cash, August 1	Brown-Forman	Morgan Stanley	$2,240	.55%
				Lenox	Kidder Peabody	$2,865	.70%

*Fortune estimate. *Lead manager. N.A. Not available.
[7]Bren previously owned 34.5%. He purchased the additional 51.5% from five private investors.
[8]Allen & Co. represented Donald Bren in the purchase of Irvine stock. First Boston rendered an opinion concerning the subsequent merger of Newco and Irvine.
[9]For the quarter ending December 31, 1982, Chrysler common stock had a book value of -$5.61.

BIGGEST DEALS OF 1983

Rank	Value of deal (000)	Percent of book value	Transaction	Companies	Financial intermediaries	Fee (000)	Fee as percent of deal
47	**BANKAMERICA sells preferred stock**						
	$400,000		Offering of four million shares of cumulative adjustable-rate preferred stock, series B at $100 per share, February 14	BankAmerica	Salomon Brothers*, Blyth Eastman Paine Webber*, Goldman Sachs, First Boston, Merrill Lynch White Weld, Dean Witter Reynolds	$8,000	2.0%
	CITICORP sells preferred stock						
	$400,000		Offering of four million shares of adjustable-rate preferred stock, second series at $100 per share, February 18	Citicorp	Goldman Sachs*, First Boston, Merrill Lynch White Weld, Salomon Brothers	$7,200	1.8%
	MCI COMMUNICATIONS sells debentures						
	$400,000		Offering of 7.75% convertible subordinated debentures due 2003, March 11	MCI	Shearson/American Express*, Drexel Burnham Lambert	$6,000	1.5%
	FEDERAL NATIONAL MORTGAGE ASSOCIATION sells debentures						
	$400,000		Offering of 11.75% debentures due 1988, December 12	Federal National Mortgage Association	Various dealers	$760	.19%

*Lead manager.

EXPLANATORY NOTES

Deals eligible for the list include:

1. U.S. public offerings of individual securities (except short-term securities) by domestic and foreign corporations issued under a single prospectus or offering circular.
2. Cash tender offers by domestic corporations or by foreign corporations tendering in the U.S., including those of companies buying in their own stock.
3. Mergers or acquisitions in which the buyer and/or seller is a U.S. company (or part of one). To be eligible, offerings must be effective in 1983 and tender offers must have expired during the year. Mergers and acquisitions are eligible if legally closed during the year or, when not legally closed, if the prospective buyer has paid a portion of the purchase price in cash during the year.

The list excludes short-term financings, government securities, and financings other than public offerings—such as bank borrowings and private placements.

When two companies merge through an exchange of stock to form a new company, the company whose stockholders received the largest share of the new company is treated as the buyer. When the buyer or seller is a subsidiary, the parent's name is given in brackets.

Value of deal Amounts for cash offerings are the total amounts raised, for tenders the total amount paid. All securities issued in acquisitions or mergers are valued at the market price on the date of closing. Exception: when a new company is formed by merger, only those shares issued to stockholders of the smaller company are valued.

Percent of book value Book value calculations indicate the price paid (or amount of equity capital raised) per share as a percentage of the shareholders' equity per share of the acquired company (or issuer) at the end of the last quarter preceding the transaction.

Transaction Dates under this heading are effective dates for offerings, expiration dates for tenders, and closing dates for acquisitions and mergers.

Financial intermediaries For underwritten public offerings, the co-managers are listed and the lead manager is indicated by an asterisk. In the case of acquisitions and mergers, the intermediaries are typically investment banking firms that assisted in the transaction.

Fee The figures represent the amounts charged by the financial intermediaries assisting in the deals. In underwritings, part of the fee is paid to other members of the underwriting syndicate or to dealers other than the co-managers.

HOW THE CHAMPS DO LEVERAGED BUYOUTS

■ Not the least of the claims of Kohlberg Kravis Roberts & Co., the nation's leading specialist in leveraged buyouts, is that the equity invested in its deals has grown at the extraordinary average annual rate of 62%. Most of the profits are in private companies whose value is fixed by appraisal, but two companies KKR took private in leveraged buyouts later went public again at much loftier share prices—seven times higher in one case and 24 times higher in another.

Normally KKR, an investment banking firm based in New York and San Francisco, does not tout its profitability. Such is the firm's record—and such is the current vogue for leveraged buyouts of industrial corporations—that KKR has little trouble raising money for more and larger deals. But KKR is currently putting together a $1-billion equity pool, its biggest yet, and a little bragging never hurts. The partners started marketing the pool in November and by mid-December had commitments totaling $660 million; they expect to reach their goal in March.

The pool, often called a fund, is not a pot of cash collected in advance. It's an investment partnership with commitments from institutions that participate as limited partners, pledging sums ranging from $15 million to $100 million. KKR, acting as general partner, draws on the commitments at will when it puts together a deal.

A BILLION DOLLARS in equity can support acquisitions costing many times that amount, for huge borrowings are the essence of leveraged buyouts and their great attraction. The ratio of debt to equity can be 4 to 1, as in KKR's biggest recent deal, and as high as 10 to 1. These enormous debt loads are supported solely by the assets and cash flow of the acquired company. Often the assets are mortgaged, and when they are not—as in most of KKR's deals—the lenders prudently encumber the company with various restrictive covenants, such as a pledge not to mortgage the assets elsewhere.

When a deal lives up to its promise, all the players win rich rewards. As a spur to greater effort, the top managers of the acquired company generally get a substantial chunk of equity—indeed, the deals are often called management buyouts. The venture capitalists who put up the risk money get that handsome return KKR boasts about. Lenders earn high interest rates plus "equity kickers"—warrants or common stock available gratis or at bargain prices. Prudential Insurance Co., which has been financing leveraged buyouts since the early 1960s, calculates that its $2-billion buyout portfolio earns 4% a year more than single-A corporate bonds bought at the same time.

Not a month goes by without another huge buyout making headlines. Last September, Wometco Enterprises Inc., a Miami-based company big in broadcasting and soft drink bottling, announced its sale to KKR for $842 million. The following month KKR agreed to buy Amstar, the sugar processor, for $430 million. In November, Forstmann Little, a rival of KKR, signed to take over Dr Pepper, the soda pop company, for $527 million. Then, in December, the four top officers of Metromedia, the broadcasting chain, announced a proposal to purchase the company for $1.1 billion—the largest sum so far offered in a leveraged buyout.

Intense rivalry often develops for companies on the block. A few weeks after Dr Pepper accepted Forstmann Little's offer, Castle & Cooke, the Hawaiian food company, offered $33 million more. Rebuffed by Dr Pepper's board, Castle & Cooke raised its bid by $21 million, only to get the cold shoulder again. Last summer Norton Simon found itself the unwilling target of competitive bids. David Mahoney, then C.E.O., made the first move when he and a group of partners offered to acquire the company for $725 million in a leveraged buyout. Eight days later KKR topped Mahoney with a bid of $825 million, only to lose out when Esmark Inc., the Chicago-based conglomerate, went to $1 billion and took over the company in a conventional merger that ranked as the 13th-largest deal of the year (see story on page 54).

The auction atmosphere has inevitably sparked concern among lenders and investment bankers that the pricing may be getting extravagant and the leveraging excessive. Nobody cites a specific imminent disaster, but news stories about the latest big deal fan the kind of free-floating anxiety felt when markets get frothy.

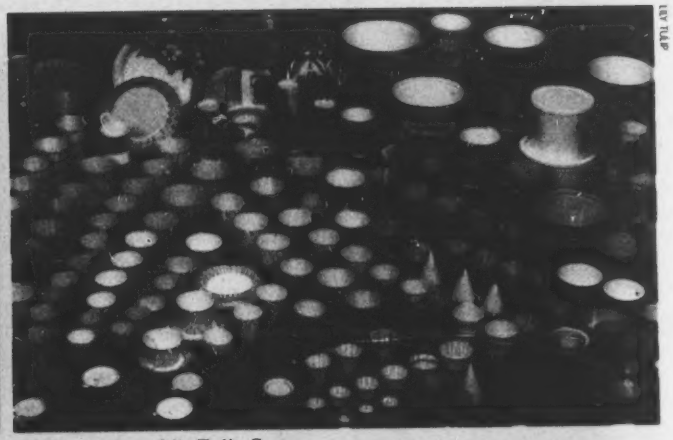
ONE CAUSE of anxiety is the number of new players, many relatively inexperienced, who have plunged into the buyout game. Until 1980 KKR shared the field with a small group of specialized investment banking houses, all of modest size—among them, Forstmann Little, Gibbons Green van Amerongen, Clayton & Dubilier, Carl Marks, and Jordan Co. Today many more leveraged buyout "boutiques" have sprung up around the country. Large investment banking houses have also been attracted to the business. First Boston, Merrill Lynch, and Morgan Stanley have all put together large deals.

But the publicity generated by the rash of recent deals has tended to obscure rather than clarify the true nature of the business. KKR and its competitors are not about to take over the FORTUNE 500. The firms operate in a well-defined segment of investment banking, specializing in seasoned, undervalued companies. At first leveraged buyouts were an essential element in what has been called the deconglomeration of America—a process whereby swollen, unfocused corpo-

RESEARCH ASSOCIATE *Katharena Leanne Zanders*

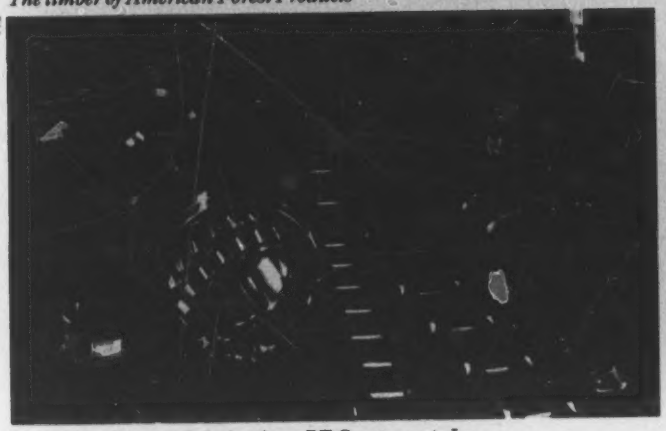
AMERICAN FOREST PRODUCTS

The timber of American Forest Products



LILY TULIP

Dixie cups from Lily Tulip Co.



PTC

Gears, bearings, and chains from PT Components Inc.

DILLINGHAM

The tugboats and barges of Hawaii's Dillingham Corp.

The Mundane Empire of KKR

In KKR's search for leveraged deals, high-flying, high-tech companies are taboo; they're considered too costly and risky. The firm's targets have been mature companies with reasonable growth rates in unexciting products and services, some shown here. The companies need big cash flows to pay off the heavy debt floated when they change hands—the essence of a leveraged buyout.

rations shed divisions they didn't know how to manage (see "How I'm Deconglomerating the Conglomerates," by Royal Little, FORTUNE, July 16, 1979). Since then buyouts have become an anti-merger weapon as well. A company trying to snap up another may face a competitive bid from KKR. What the buyout phenomenon illustrates, above all, is the endlessly ingenious creativity of American capitalism.

KKR is the acknowledged champ at what it does. In the last seven years it has completed 18 buyouts, six of them for over $300 million each, for a total outlay of $3.5 billion. It has been well paid for its efforts. The firm gets the standard investment banking fee of around 1% for putting a deal together; it usually invests that fee in the stock of the acquired company. KKR also receives consultant fees ranging between $150,000 and $300,000 a year from each of the companies in its portfolio, now numbering over a dozen. Two or three partners sit on the boards of KKR's companies and collect directors' fees; they control the boards on behalf of the investors the firm brought into the deal. In addition KKR receives a 1.5% annual fee on the money sitting in its equity pool but not yet invested—$15 million at the outset from the billion-dollar fund.

The greatest wealth creator, though, is KKR's outsize share in potential capital gains. As general partner it is entitled to 20% of any appreciation its equity partners realize. That 20% share is standard in the buyout business, as in venture capital funds.

THE FOUNDING PARTNERS who share this largess—Jerome Kohlberg Jr., 58, Henry Kravis, 40, and George Roberts, 40—are an extraordinarily discreet trio. They pride themselves on their low profile and over the years have generally avoided contact with the press. Though they allowed FORTUNE a lengthy inside view of their operations, they were frequently skittish when questioned closely, particularly about their personal enrichment. "We are very private people," Jerry Kohlberg, the senior partner, kept insisting.

Kohlberg is the most tight-lipped of the three, with a reserve as impenetrable as a two-foot-thick vault door. There is also something rather prim and constricted about his appearance—largely a matter of his rimless eyeglasses and the tiny knot, almost disappearing under his collar, in his unfashionably thin tie. His caution is legendary. On one rainy morning in Washington, a colleague recalls, Kohlberg ventured forth encased in galoshes, a trench coat, a scarf, and a floppy hat, with an umbrella in hand. "I thought I'd be prepared," he explained. With an interviewer his caution is so extreme that he sometimes pauses 30 seconds before responding to a question. And he never received this writer without being chaperoned by his outside P.R. counsel.

The younger partners, Kravis and Roberts, are a bit more daring in their haberdashery—favoring white collars and white French cuffs on dark shirtings—and more

forthcoming in their manner. They are the activists in the firm, searching out the target companies, stitching together most of the deals, and signing up participants in the equity pools. They are first cousins and are both short, dark, and wiry. Kravis is the more volatile of the two and occasionally can be abrasive. A longtime employee of the firm, Robert MacDonnell, 46, became the fourth partner early in 1982. Like his colleagues, he's devoted to tennis, the ruling avocational passion in the firm.

When Kohlberg Kravis Roberts & Co. began business in May 1976, its founding partners had already been doing leveraged buyouts for several years. Kohlberg, a native New Yorker who has both a law degree and an MBA, had worked at Bear Stearns since 1955 and eventually became head of its investment banking department. In 1965 he undertook his first leveraged buyout, largely by chance. The term was hardly ever used at the time.

H. James Stern, then 72 and the head of a suburban New York company called I. Stern, which produced precious metal alloys, had come to see Kohlberg with a problem. Stern wanted to put his estate in order and was thinking either of selling his business or going public. "I suggested that he could have his cake and eat it too," says Kohlberg, who put together a deal and bought the company for $13.8 million. The new owners of the company, renamed Stern Metals, were Bear Stearns, the Paul Revere Insurance Co., and the old management. The company did well and went public with stock offerings in 1966 and 1967. Bear Stearns ultimately distributed its 40% of the shares to its partners, who sold out at $20 a share—a gain of $17.50. Kohlberg, who had been allocated 10,000 shares, made a profit of $175,000.

LEVERAGED BUYOUTS, he realized, were clearly a good thing. He did three more in 1966 and another in 1969 when he was assisted by Kravis and Roberts, who had just joined the firm. Their first flop came in 1971, when they bought out Cobblers Inc., a shoe company headquartered in Los Angeles, for about $20 million. The former chief executive stayed on, considerably enriched by the deal, but six months later he committed suicide. Kohlberg tried two other C.E.O.s in quick order, but found no one capable of running the company. He ultimately sold it off in pieces, losing $400,000 for the equity investors. The lenders recovered their money.

In 1972, however, came a big winner in Vapor Corp., a manufacturer of valves and pumps, which the partners bought for $36.5 million from the financially troubled Singer Co. The Vapor deal was highly leveraged, with 88% long-term debt to 12% equity. The interest rates on the various classes of debt were high for that era—as much as 9.5%. But the company's cash flow was good and earnings increased rapidly, which made it possible to repay much of the debt in the first few years. The common stockholders paid $2.80 a share and got $33 a share when the company was sold to a subsidiary of the Brunswick Corp. in 1978. In 1975 the partners brought off an even bigger coup, paying $1 a share for Incom, a manufacturer of industrial components being shed by Rockwell International. They got $22 a share when they sold Incom in 1981.

The biggest joy of the leveraged buyout is one familiar to a homeowner charging off large mortgage payments on his 1040. Operating profits not covered by depreciation allowances are largely offset by interest payments. Uncle Sam is a silent partner in the deal.

Shortly after they purchased Incom, the partners went into business for themselves. Then as now, they were looking for mature companies with predictable cash flows, decent growth prospects, little long-term debt, and modest future capital requirements—companies that could be leveraged to the hilt. They wanted well-run companies, whose management hankered for a share of the equity. They wanted companies with "market niches," to use a well-worn phrase in the buyout business, that protected them from severe competitive pressures.

Once KKR leverages a company with a lot of debt, its technique is to speed up cash flow to retire loans as quickly as possible. Whenever possible, the firm writes up the company's assets to the present cost level for tax purposes rather than carry them at historical cost; this makes it possible to charge more depreciation. The gambit is avoided, however, if the company previously took a lot of depreciation or used substantial investment tax credits. Under the tax laws the company can be hit with a "tax recapture" that would outweigh the benefits it might get by boosting depreciation. Other ways of generating more cash include paring inventories, accelerating the collection of receivables, and delaying bill payments to the maximum.

But the biggest joy of the leveraged buyout is one familiar to any homeowner charging off large mortgage payments on his 1040. Operating profits not covered by depreciation allowances will be largely offset by those huge interest payments. In the early years after a buyout, many companies pay little or no corporate tax. Uncle Sam is a silent partner in the deal.

PRECISELY BECAUSE equity is such a small part of a bought-out company's total capitalization, a leveraged deal can become immensely profitable. As the debt is paid down, the equity portion grows rapidly, as does the book value per share. Vapor's debt-equity ratio, nearly 5 to 1 in 1973, was swiftly reduced to 1 to 2 by 1976. Per-share book value soared from $3.45 to $10.42. Such are the blessings of high leverage.

KKR made its reputation not only because its deals worked out, but because it demonstrated that very large transactions were feasible. Prior to 1979 no one did a leveraged buyout for much over $100 million. Then, in the spring of 1979, KKR brought off the $355-million purchase of Houdaille Industries of Fort Lauderdale, Florida, a manufacturer of pumps, machine tools, and automotive products. It was a most elaborate financial design—highly "creative," as they say in the trade. Continental Illinois, Bankers Trust, and Manufacturers Hanover put up $60 million in revolving credit. Then came $140 million in senior notes and $75 million in senior subordinated notes, followed by $31.5 million in junior subordinated notes; the lenders were 23 institutions, mostly insurance companies. The lenders got a big "equity kicker"—over half of the voting common stock—while KKR and its venture partners picked up the rest of the $48.4 million equity. All the equity money is still at risk, but KKR reports that Houdaille is showing respectable earnings and has repaid a substantial portion of its debt.

More large deals followed. In 1981, KKR and its partners bought seven companies, one for $381 million and three for over $400 million each. Norris Industries of Long Beach, California, traveled full circle from public to private to public company in a mere 22 months. In December 1981 KKR paid $420 million for this manufacturer of automobile, household, and defense products (projectiles, cartridge cases). Renamed NI Industries, the company went public again last October, in the process enriching everybody involved with the deal.

When taken private, NI Industries was highly leveraged, with a debt-to-equity ratio of nearly 9 to 1. Initially it suffered from the steep decline in the auto and housing indus-

THE TEN BIGGEST LEVERAGED BUYOUTS

COMPANY	DATE	INVESTMENT BANKER	AMOUNT
Wometco	Pending	Kohlberg Kravis Roberts	$842 million
Conoco Chemicals	Pending	E.F. Hutton Group	$600 million
Dr Pepper	Pending	Forstmann Little	$527 million
Congoleum	1980	First Boston	$448 million
Signode	1982	Merrill Lynch	$430 million
Amstar	Pending	Kohlberg Kravis Roberts	$430 million
Bendix Forest Products	1981	Kohlberg Kravis Roberts	$425 million
Norris Industries	1981	Kohlberg Kravis Roberts	$420 million
Fred Meyer	1981	Kohlberg Kravis Roberts	$420 million
Purex Industries	1982	Gibbons Green van Amerongen	$390 million

Leveraged buyouts have been getting bigger. The three biggest on this list, which includes those agreed upon as well as those consummated, are still pending. Not included is a recent offer by Metromedia's top officers to buy the company for $1.1 billion, since no deal has been struck. In the case of Conoco Chemicals, Du Pont is selling off only part of a business it acquired in 1981.

tries. Nonetheless it was able to reduce its long-term debt substantially, slicing off $30 million in 1982 and $87 million in the first nine months of 1983. Some of the proceeds from a public stock issue last fall knocked off another $67 million. Earnings also improved substantially as the auto and housing industries revived. NI stock, brought out at $20 a share—a sevenfold increase from the $2.75 that the stockholders paid when the company went private—has recently traded as high as $23 a share.

The steep run-up could greatly enrich KKR. It will not say how much NI stock the four partners own, though it is small in comparison to their limited partners' stake. But the big windfall for KKR could come from its 20% interest in any capital gains on the 7.4 million shares owned by its limited partners. KKR collects only when the capital gains are realized, so for the present it has a paper profit. But at the recent market price that 20% share translated into a $28-million gain.

Disarmingly, the partners do not plead that high risk justifies the high rewards in their business; they insist that the deals themselves are not risky. They could hardly argue otherwise, of course, and maintain their posture of prudent investment bankers. The risks they concede are of deals that fall through, which can involve expenses as high as $500,000. Three times last year KKR mounted serious offers for companies—including Norton Simon—only to lose out to higher bidders.

THE RISKS, in fact, are bigger than KKR acknowledges. By far the major financing tools these days in large buyouts are revolving credit bank loans at two or three points above prime. If interest rates shoot up again, there could be serious pressure on many of the newly private companies. A cyclical downturn in the economy could also hurt badly, as it has in the past. Back in 1981, KKR paid $425 million for Bendix Forest Products, soon renamed American Forest Products. It got the trees at a high point in the market, after which the forest products business plummeted along with housing construction. KKR had to return part of the land to Bendix, in exchange for canceling a $65-million debt. In the process KKR and its partners lost $5 million of their $95 million in equity.

The great fear among lenders is that the intense competition for properties is driving up prices to unrealistic levels. "Too much money chasing too few deals" is the standard diagnosis. The banks and insurance companies talk of the dubious deals they have turned away, but generally will not specify which ones. Not only is bidding intense, but valuations have gone up enormously since the bull market in stocks began in August 1982. The price of private companies too has been affected by the market surge.

On the other hand, no company involved in a big buyout deal has yet gone belly-up. The few bankruptcies resulting from deals in recent years, such as Brentano's and Havatampa, all involved relatively modest transactions. Prudential reports that while 5% to 15% of its $2-billion buyout portfolio is in trouble at any one time, the profitability of the portfolio as a whole remains robust. The price the insurance company exacts for its loans allows a margin of error.

Eyebrows rose when KKR disclosed its plan to pay $842 million for Wometco. The company is in several businesses—cable TV, movie theaters, and vending machines, as well as broadcasting and soft drinks. KKR will be paying seven or eight times pretax cash flow—high in the view of some. Kravis, understandably, argues that the price is not too high. He points out that the multiples for each of the businesses, taken separately, would be in line with what the market has recently paid for similar operations. Moreover, Kravis reports that he has had no trouble arranging financing. But banks have been wrong before.

KKR's own portfolio of companies is sufficiently diversified so that it faces no great risk to its net worth if a big deal should go sour—nor do its limited partners. The real risk would be to KKR's credibility. If one of its large companies failed and the lenders were seriously nicked, KKR would lose a lot of momentum.

On the whole, however, KKR is regarded as a prudent promoter. Even its competitors are eager to praise it, for its success helped enlarge the buyout game for everybody. Investors can be extravagant in their compliments. "You are present at the creation of another great American fortune," says Timothy Hay, president of Security Pacific Capital Corp., the venture capital arm of the big Los Angeles bank. "A reasonable minimum return on that billion-dollar pool would be about 20% a year. When that billion doubles, KKR will make $200 million." At a 20% compound growth rate, it would take less than four years.

■ Recently Jerry Kohlberg was a little startled when asked what economic or social benefit KKR delivered to justify such enormous rewards. But he recovered quickly and produced an answer: KKR promotes economic efficiency by giving managers a stake in their businesses and thus an incentive for better performance. And all these buyouts help to redeploy capital, making it available for other users. ■